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SUBJECT: SRI LANKA INVESTMENT CLIMATE STATEMENT APPENDIX, 2004

REF: (A) STATE 141379 (B) 03 COLOMBO 001389

Sri Lanka - July 2004 Appendix to 2003 Investment Climate Statement

1. This appendix serves as an update to the 2003 Investment Climate Statement for Sri Lanka. It has been provided to assist investors in the interim period resulting from the U.S. Government's decision to begin publishing the Country Commercial Guide (of which the Investment Climate Statement is a chapter) on a calendar year basis, in January instead of August.
2. The United States Government has reviewed the 2003 Investment Climate Statement for Sri Lanka, and has noted the following changes that have occurred since its publication. In most circumstances, if a portion of the 2003 Investment Climate Statement has not been modified in this appendix, it is because the U.S. Government is satisfied that it continues to accurately reflect the state of affairs in Sri Lanka as of July 2004.
3. The following are keyed to updates requested in Ref A:

Openness to Foreign Investment: Since the last Investment Climate Report, there was a change of government in Sri Lanka. In early February 2004, President Chandrika Kumaratunga dissolved the Parliament, following the failure of the two major political parties to come to an agreement on how to break an impasse over control of ministries and steps to move the peace process forward. Consequently, Parliamentary elections were held on April 2 and the United People's Freedom Alliance (UPFA), a left leaning coalition comprising the Sri Lanka Freedom Party (SLFP) and Marxist Janatha Vimukthi Peramuna (JVP), formed a government. However, it failed to gain a majority in Parliament.

A Norwegian brokered ceasefire, between the LTTE and the Government, in effect since February 23, 2002, continues to hold despite LTTE withdrawal from peace talks in April 2003. LTTE presented its proposals for an interim administration in October 2003. Efforts to restart peace talks have floundered.

The UPFA contested the election on a platform of pro-poor growth policies. The Government's Economic Policy Framework "Creating Our Future, Building Our Nation" <http://www.treasury.gov.lk> focuses on development of the small and medium enterprise sector (SME), agriculture, infrastructure, with a much heavier reliance on Government. The Government also hopes to facilitate private investment through market friendly, export oriented strategies supported by a strong regulatory and legal framework. The Government has abandoned plans to privatize strategic state enterprises. Instead, the Government will retain ownership and management of these enterprises ranging from large state-owned banks to electrical utilities. The Government hopes to insulate them from political interference and make them profitable. The Government has created three new agencies to improve state owned enterprises, economic development, and procurement.

The Government has rejected the former Government's poverty reduction strategy paper titled "Regaining Sri Lanka" citing its failure to benefit the poor and rural areas. However, it has indicated a strong desire to continue with various reforms begun by the former government.

The Government acknowledges the vital role played by both foreign and local private investors in the economy. The Government has promised to encourage both foreign and local private investment through the removal of impediments and an introduction of an investor friendly administration. However, there have been efforts to introduce prohibitive new taxes on the acquisition of land by foreigners and other bureaucratically inspired impediments to foreign investments. The Government encourages adoption of best practices in the corporate sector, and hopes to rely on a healthy corporate sector to facilitate investment. The Government welcomes environmentally friendly, socially responsible investments.

Pending clarity on economic and fiscal policies, the IMF has withheld disbursements under a Poverty Reduction Growth Facility (PRGF) and Enhanced Fund Facility (EFF) extended to Sri Lanka in April 2003.

The Sri Lankan Rupee has depreciated by about 5 percent during the first seven months of 2004, due to political uncertainty. There has been a slowdown in aid and investment inflows. In addition, Sri Lanka's trade deficit has also expanded due to a heavy oil import bill. Gross official receipts have slipped 13% in the first five months. Total reserves at \$3.1 billion, provides 5.3 months of import cover. The currency is likely to depreciate further in the next few months.

Conversion and Transfer Policies: No significant changes since 2003.

Expropriation and Compensation: No significant changes since 2003.

Dispute Settlement: There continue to be trade and investment disputes, particularly surrounding Government procurement. The procurement process in Sri Lanka is slow and non-transparent. US companies continue to face problems with payment on valid contracts, implementation on agreements with the Government and inexplicable failure to secure contracts, despite high value and low bids.

Performance requirements and investments: No significant changes since 2003.

Right to private ownership and establishment: The Government is considering changing land ownership regulations and there are calls for the imposition of a substantial tax on land sales to foreigners. Under previous versions of this tax foreign companies registered in Sri Lanka were considered local companies and were not liable. In its current form, however, any company with 25% foreign ownership would be considered "foreign" for the purposes of the tax.

Protection of Property Rights: No significant changes since 2003.

Transparency of the regulatory System: No significant changes since 2003.

Efficient Capital Markets and Portfolio Investment: No significant changes since 2003.

Political Violence: There has been an uptick in violence, mostly in the Eastern part of the country, related to infighting between the Liberation Tigers of Tamil Eelam (LTTE) terrorist organization, and a faction that split from the LTTE earlier this year. In July, there was a suicide bombing in a Colombo police station. Five people (including the bomber) were killed. The bombing bore the hallmarks of an LTTE attack. Despite these incidents, the ceasefire largely holds and both sides have publicly committed to its maintenance.

Corruption: No significant changes since 2003.

Bilateral Investment Agreements: The US-Sri Lanka Income Tax Treaty went into effect on June 12, 2004.

OPIC and Other Investment Insurance Programs: No significant changes since 2003.

Labor: The Government continues to take steps to improve enforcement of labor regulations inside export processing zones (EPZs). The Board of Investment (BOI) has recently issued revised instructions to BOI companies to facilitate union activity within their factories. In addition, employers were requested to allow trade union access to EPZ factories. Previously, in October 2002, the BOI instructed BOI companies to recognize trade unions and the right to collective bargaining. ILO has confirmed that non-union employee councils and trade unions can coexist.

Labor Management Relations: There is a new thrust on corporate social responsibility. Sri Lanka is trying to focus international attention to high social compliance in the corporate sector in the wake of the MFA-phase out.

Foreign Trade Zones/Free Ports: No significant changes since 2003.

Foreign Direct Investment Statistics: Statistics will be updated in the next full revision of the Investment Climate Statement, which will be published in January 2005.

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